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REHABILITATION TAX CREDIT[1]

Scheduled for Markup by the Ways and Means Subcommittee on Select Revenue Measures

Present Law

In general

A credit is provided for expenditures incurred in rehabilitation of certified historic structures and certain nonresidential buildings placed in service before 1936. The amount of the credit is determined by multiplying the applicable rehabilitation percentage by the basis of the property that is attributable to qualified rehabilitation expenditures. The applicable rehabilitation percentage is 20 percent for certified historic structures and 10 percent for qualified rehabilitated buildings (other than certified historic structures) that were originally placed in service before 1936.

Eligibility for 10-percent credit

A nonresidential building that was originally placed in service before 1936 is eligible for the 10-percent rehabilitation credit only if the building is substantially rehabilitated and a structural requirement is satisfied. For this purpose, a building is considered substantially rehabilitated only if the qualified rehabilitation expenditures incurred during a 24-month period selected by the taxpayer exceed the greater of (1) the adjusted basis of the building as of the later of the first day of the 24-month period or the beginning of the taxpayer's holding period for the building, or (2) $5,000. In the case of any rehabilitation that is reasonably expected to be completed in phases set forth in architectural plans or specifications completed before the rehabilitation begins, a 60-month period may be used.

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[1] For a description of present law and a discussion of issues, see Joint Committee on Taxation pamphlet, Present Law and Issues Relating to the Low-Income Housing and Rehabilitation Tax Credits (JCS-12-89), May 12, 1989.

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A building satisfies the structural requirement only if (1) at least 50 percent of the existing external walls of the building are retained in place as external walls, (2) at least 75 percent of the existing external walls are retained as external or internal walls, and (3) at least 75 percent of the existing internal structural framework of the building is retained.

Eligibility for 20-percent credit

A residential or nonresidential building is eligible for the 20-percent credit that applies to certified historic structures only if the building is substantially rehabilitated (as determined under the eligibility rules for the 10 percent credit). In addition, the building must be listed in the National Register or the building must be located in a registered historic district and must be certified by the Secretary of the Interior as being of historical significance to the district. While the structural requirement under the 10-percent credit does not apply, the Secretary of the Interior is expected to deny certification in cases of substantial new construction rather than rehabilitation.

Definition of qualified rehabilitation expenditure

The income tax credit for rehabilitation expenditures is available only with respect to the portion of the basis of the rehabilitated building that is attributable to qualified rehabilitation expenditures. A qualified rehabilitation expenditure is any expenditure properly chargeable to capital account, incurred in connection with rehabilitation of a building eligible for the rehabilitation credit, for certain depreciable real property. A qualified rehabilitation expenditure does not, however, include the cost of acquiring the building or an interest in it (such as a leasehold interest), the cost of facilities related to a building (such as a parking lot), or the cost of enlarging a building.

In addition, an expenditure is not a qualified rehabilitation expenditure unless depreciation or cost recovery with respect to the expenditure is determined under the straight line method, and (in the case of lessee expenditures) unless any remaining lease term upon completion of the rehabilitation is less than the recovery period (generally, 27.5 years for residential rental buildings and 31.5 years for nonresidential buildings).

Basis reduction and credit recapture

The basis of any property eligible for the rehabilitation credit is reduced by the full amount of the allowable credit. No cost recovery allowance or depreciation deduction is allowed for rehabilitation expenditures that are

considered funded by the rehabilitation credit.

In addition, the rehabilitation credit is subject to recapture if the rehabilitated building is disposed of or otherwise ceases to be qualified investment property at any time during the five year period beginning after the year the property is placed in service.

Restrictions on use of credit to offset tax

The rehabilitation credit is subject to the rules of the general business credit, including the maximum amount of income tax liability that may be reduced by a general business credit in any one year. This limitation generally is equal to the excess (if any) of the taxpayer's net income tax over the greater of (1) the taxpayer's tentative minimum tax for the year, or (2) 25 percent of so much of the taxpayer's net regular tax liability as exceeds $25,000. Thus, the credit may not offset the taxpayer's alternative minimum tax.

Unused credits generally may be carried back 3 taxable years and then forward 15 years (to the extent permitted by other applicable limitations, if any).

Passive loss restrictions on credit use

In general

Under the passive loss rule, deductions from passive trade or business activities or rental activities, to the extent they exceed income from all such passive activities (exclusive of portfolio income), generally may not be deducted against other income. Similarly, credits from passive activities generally are limited to the tax attributable to the passive activities. Suspended losses and credits are carried forward and treated as deductions and credits from passive activities in the next year. Suspended losses from an activity are allowed in full when the taxpayer disposes of his entire interest in the activity. The rule applies to individuals, estates, trusts, and personal service corporations. A special rule limits the use of passive activity losses and credits against portfolio income in the case of closely held corporations.

Special rules

$25,000 allowance in the case of rental real estate activities.--A special rule is provided for passive activity losses and credits attributable to rental real estate activities. In the case of rental real estate activities, an individual may deduct up to $25,000 of passive activity losses (to the extent they exceed income from passive activities) if the taxpayer actively participates in the

rental real estate activity (and has at least a 10 percent interest in it). The $25,000 amount is phased out ratably as the taxpayer's adjusted gross income, with certain modifications, increases from $100,000 to $150,000.

$25,000 allowance for low-income housing and rehabilitation credits.--Under a special rule, the $25,000 allowance also applies to low-income housing and rehabilitation credits (on a deduction-equivalent basis), regardless of whether the taxpayer claiming the credit actively participates in the rental real estate activity generating the credit. In addition, the adjusted gross income phaseout range from the $25,000 amount for these credits is from $200,000 to $250,000 (rather than the generally applicable phaseout range of $100,000 to $150,000).

Possible Option

The Subcommittee could modify the application of the passive loss restrictions to the rehabilitation credit by removing the adjusted gross income limitations on the $25,000 deduction equivalent allowance of the credit with respect to rental real estate activities. Thus, up to a $25,000 deduction equivalent amount of rehabilitation credits would be available to an individual under the possible option, regardless of his adjusted gross income. The possible option would otherwise retain present law with respect to the rehabilitation credit.

Effective Date

The possible option would be effective in taxable years ending after December 31, 1989, for property placed in service after December 31, 1989. In addition, if the property is held through a partnership or other passthrough entity, the taxpayer's interest in the partnership or other passthrough entity must have been acquired after December 31, 1989.

Revenue Effect of the Possible Option

The possible option is estimated to reduce fiscal year budget receipts by $8 million in 1990, $21 million in 1991, $29 million in 1992, $39 million in 1993, and $48 million in 1994.